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In the Supreme Court of the United States

OCTOBER TERM, 1939

PEARL E. DEPUTY AND THE SUSSEX TRUST CO., A CORPORATION OF THE STATE OF DELAWARE, AS ADMINISTRATRIX AND ADMINISTRATOR OF THE ESTATE OF WILLARD F. DEPUTY, DECEASED, LATE COLLECTOR OF INTERNAL REVENUE, PETITIONER

v.

PIERRE S. DU PONT

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

The Solicitor General, on behalf of Pearl E. Deputy and the Sussex Trust Company, a corporation of the State of Delaware, as administratrix and administrator of the Estate of Willard F. Deputy, deceased, late Collector of Internal Revenue for the District of Delaware, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Third Circuit, entered in the above entitled cause on March 28, 1939, reversing the decision of the District Court of the United States for the District of Delaware.

OPINIONS BELOW

The opinion of the District Court (R. 208–243) is reported in 22 F. Supp. 589. The opinion of the Circuit Court of Appeals (R. —) is reported in 103 F. (2d) 257.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 28, 1939 (R. —). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the expenditures in question are deductible from gross income as ordinary and necessary business expenses.

STATUTE INVOLVED

Revenue Act of 1928, c. 852, 45 Stat. 791:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME. In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *.
>
> SEC. 24. ITEMS NOT DEDUCTIBLE.
>
> (a) *General rule.*—In computing net income no deduction shall in any case be allowed in respect of—
>
> (1) Personal, living, or family expenses;

* * * * *

STATEMENT

At the close of the World War the du Pont Company foresaw that its business, which up to that time had been chiefly the manufacture of munitions and war supplies, would have to be changed. It was thought desirable for the conduct of peacetime affairs to appoint a new executive committee of the corporation (R. 209–210). In order that the nine members of the executive committee might devote their best time and energy to the interests of the company, the chairman of the board, early in 1919, recommended to the finance committee that the question of proper compensation for the new members of the executive committee be taken up by a special committee, which was done (R. 210). The plan recommended involved, among other things, the issuance to each executive committeeman of 1,000 shares of stock in the company at $400 per share, to be paid off in part by a $150,000 bonus at the end of five years. The company's counsel, however, advised that the corporation had no power to carry out this arrangement, since under Delaware law stock could not be issued for future services, and stock issued for cash had first to be offered to existing stockholders pro rata (R. 211). Thereupon, Pierre S. du Pont, the taxpayer, at the instance of the du Pont Company, agreed to sell to each of the committeemen, at the asset value, 1,000 shares of du Pont Company stock (R. 212–213).

In entering into the above transaction, the taxpayer did not have the purpose or intention of

making a profit from the sale, but he did have the purpose and intention to conserve and enhance the value of his own substantial beneficial stock holdings in the du Pont Company (R. 213).

The taxpayer did not have available 9,000 shares of the common stock of the du Pont Company for this purpose, for in December, 1919, he owned only 74 shares. He had a reversionary interest in two trusts created by him which held 24,000 shares. He was also a substantial stockholder in the Christiana Securities Company which was the largest single owner of du Pont Company stock, owning 183,000 shares out of a total of 588,512 shares issued and outstanding (R. 213).

In order to secure the stock which he had agreed to sell, he arranged with the Christiana Securities Company to lend him 9,000 shares. The resolution of the Christiana Securities Company authorizing the loan recited that the company was the principal stockholder of the du Pont company and interested in its success. The terms of the agreement with the Christiana Securities Company were in substance that he would return similar shares at the end of a ten-year period, and in the meantime would pay to the Christiana Securities Company amounts equivalent to all dividends declared and paid on the shares he had borrowed. Plaintiff did not enter into this agreement with the intention or purpose of making a profit thereby (R. 47, 48–49, 213–214).

Taxpayer sold 1,000 shares of the du Pont Company to each of the nine executive committeemen at $320 per share, and received $320,000 in cash from each. The men had obtained the cash from the du Pont Company, which had loaned the money to each member for a period of five years upon the basis of the du Pont stock as collateral. The Company's contract of employment with each of the members of the committee provided for an additional compensation of $150,000 if the committeeman remained in the employ of the company for the five years (R. 214–215).

By the early part of 1921 the value of du Pont Company stock had materially decreased so that it seemed possible that the committeemen, instead of receiving a benefit from the transaction, would sustain a severe loss. When this condition appeared, the taxpayer wrote to each of the committeemen a letter in which he stated the motives which had prompted him in the first instance, made plain that he had no intention to make a profit for himself from the sale to the committeemen, stated that it was still important for the company to retain the services of good men, and adjusted the original transaction with the result that he gave to each of the committeemen stock in the Christiana Securities Company having a value of $160,000, subject to an option in him to repurchase for that sum at the price of the maturity of the loan made by the du Pont Company (R. 216–217).

At the end of ten years, the taxpayer was not ready to return to the Christiana Securities Company the stock he had borrowed. He entered into an agreement with the Delaware Realty and Investment Company to lend him 142,212 shares of du Pont Company stock to discharge his obligation to the Christiana Securities Company.[1] The agreement recited that taxpayer, while not contemplating the closing of the short sale transaction of December, 1919, desired to return the shares to the Christiana Securities Company. The agreement provided that he would return the borrowed shares to the Delaware Realty and Investment Company within ten years after October 25, 1929, and in the meantime would pay to the Company amounts equivalent to all dividends declared by the du Pont Company upon the borrowed shares, together with amounts equal to any tax liability imposed upon the Delaware Realty and Investment Company, because of the receipt from the taxpayer of the aforesaid sums, which would not have accrued but for the execution of the agreement. During 1929, taxpayer returned 300 shares, reducing his obligation to 141,912 shares. (R. 98–103, 218–219.)

In 1931 the taxpayer paid to the Delaware Realty and Investment Company $567.648, a sum equal in amount to the dividends paid by the du Pont Company upon the stock borrowed as aforesaid, and an additional sum of $80,063.56, which was the

[1] The original 9,000 shares had been augmented by stock dividends (R. 217–218).

amount of federal income tax imposed upon the Delaware Realty and Investment Company by reason of the payments which it had received from the taxpayer (R. 219). These are the expenditures which are involved in the present litigation.

The taxpayer had in 1919, 1920 and 1931, large and diversified investments in stocks and securities. In 1919, he devoted about 50 per cent of his time to his investments, which consisted in a large part of du Pont Company stock. He changed his investments from time to time, but he was not a speculator and had practically no investments in brokerage accounts. By 1929 he had parted with a large part of his du Pont Company stock, but had retained a large ownership in the Christiana Securities Company; his largest holdings were then in General Motors Corporation. The District Court found that taxpayer's business was primarily that of conserving and enhancing his estate. He entered into the transaction here in question with the intention and purpose and to the end that his beneficial stock ownership in the du Pont Company might be conserved and enhanced (R. 220–221).

On his income tax return for the calendar year 1931, taxpayer deducted the amounts of $567,648, and $80,063.56, paid to the Delaware Realty and Investment Co., as aforesaid. The Commissioner in assessing and collecting a deficiency refused to allow these deductions (R. 219–220). The taxpayer brought suit for refund (R. 5–9). The District

Court granted a judgment for $54,439.52, relating to other matters, but held that the sums of $567,648 and $80,063.56 were not deductible from the gross income of the taxpayer upon any of the grounds suggested by him. (R. 208–243). Upon appeal the Circuit Court of Appeals held that the sums were deductible as ordinary and necessary business expenses (R. —).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the expenditures were proximately or directly connected with taxpayer's assumed business of conserving and enhancing his estate.

2. In holding that the expenditures were "ordinary" expenses in such business.

3. In refusing to consider the transaction as a whole and take into account the history and purpose of the borrowing of the shares.

4. In holding that the conservation of a taxpayer's estate constitutes a business.

5. In holding that Section 23 (a) of the Revenue Act of 1928 permits the deduction of amounts expended for the purpose of conserving and enhancing the taxpayer's estate.

6. In failing to hold that the sums of $567,648 and $80,063.56 were in the nature of capital expenditures which are not deductible from gross income.

7. In reversing the decision of the District Court.

REASONS FOR GRANTING THE WRIT

1. Section 23 (a) of the Revenue Act of 1928, *supra*, p. 2, permits the deduction from gross income of ordinary and necessary expenses paid or incurred in carrying on a trade or business. The decision of the court below allowing the deduction is in conflict with decisions of this Court, announcing the principles correctly applied by the trial court, and with certain decisions of the circuit courts of appeals.

Thus, this Court has settled the principle that a payment does not constitute an item deductible under Section 23 (a) unless it proximately results from, or is directly connected with, the taxpayer's business. *Kornhauser* v. *United States*, 276 U. S. 145, 153. And a stockholder's business must be sharply distinguished from that of the corporation in which he holds stock. *Dalton* v. *Bowers*, 287 U. S. 404; *Burnet* v. *Clark*, 287 U. S. 410; *Burnet* v. *Commonwealth Imp. Co.*, 287 U. S. 415; *Van Dyke* v. *Helvering*, 291 U. S. 642.

In *Burnet* v. *Clark*, *supra*, losses suffered by a majority stockholder and officer, through endorsement of obligations of the corporation, were held not net losses attributable to his business, but transactions intended to preserve the value of his investment in its capital shares. Expenditures made in the best interests of the corporation, and intended to benefit the taxpayer through his stock holdings, are capital in nature. They may not be deducted as losses (*Mastin* v. *Commissioner*, 28 F. (2d) 748 (C.

C. A. 8th); *Menihan* v. *Commissioner,* 79 F. (2d) 304 (C. C. A. 2d), certiorari denied, 296 U. S. 651; *Park* v. *Commissioner,* 58 F. (2d) 965 (C. C. A. 2d), certiorari denied, 287 U. S. 645); and, similarly, the doctrine of *Burnet* v. *Clark* precludes their deduction as business expenses. *Bing* v. *Helvering,* 76 F. (2d) 941, 942 (C. C. A. 2d).

These decisions plainly govern the present case. Taxpayer's purpose in his entire course of conduct was to conserve and enhance the value of the shares in the du Pont Company beneficially owned by him by securing an efficient management for the corporation (R. 212–213; 215–217; 221; 229). This was obviously the business of the du Pont Company itself. Indeed, the taxpayer's personal participation, at the instance of the company, came only after the company's initial proposal that the company itself compensate the executive committeemen through its shares was found constitutionally objectionable (R. 210–211, 213). Assuming, for the purpose of argument, that taxpayer was in business as an investor,[2] the payments in question were expended in the business of the corporation, and, as the District Court stated, they were not proximately or directly connected with the taxpayer's business of enhancing his investments.[3] *Kornhauser* v. *United States, supra.*

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[2] See *infra*, pp. 13–15, for a consideration of the nature of taxpayer's "business."

[3] See *Kenan* v. *Bowers,* 50 F. (2d) 112 (C. C. A. 2d); G. C. M. 670, V-2 Cum. Bull. 115.

Furthermore, the expenditure, made upon a long-term loan of securities obtained in order to cover what is essentially a short sale, was found by the District Court not to be ordinary in the lives of business men (R. 235). Accordingly, under the doctrine of *Welch* v. *Helvering,* 290 U. S. 111, 114, 115, the payment was not deductible.

2. The District Court correctly applied the foregoing principles of law to findings of fact not subject to attack. In reversing the judgment, the Court of Appeals avoided the issues discussed by the District Court by refusing to take into consideration the history and purpose of the borrowing and by viewing the situation solely from the standpoint of the necessity for the 1929 agreement.[4]

This narrow approach was its critical error.[5] It is well established that component steps of a single

[4] Even on this approach, the opinion of the Court of Appeals reflects an erroneous and unwarranted assumption of facts that the agreement was negotiated because of a positive benefit to the taxpayer. The District Court found that the 1929 agreement with the Delaware Company was not entered into with the intention of making a profit (R. 218–219). When the Court of Appeals discussed the reason for entering into the 1929 agreement, it quoted a finding which stated: "The market for du Pont Company stock was thin. Nine thousand shares of common stock of the du Pont Company could not have been purchased in the open market without substantially raising the price per share." The Court of Appeals stated (R. —) that this finding was made as to the situation "when the ten year maturity approached," i. e. in 1929. Actually the finding quoted (Fdg. 18, R. 214) referred to the situation in *1919*.

[5] The Board of Tax Appeals took the contrary position in *du Pont* v. *Commissioner*, 37 B. T. A. 1198, 1273.

transaction are to be viewed as a whole and may not be treated separately for tax purposes. *Commissioner* v. *Ashland Oil & R. Co.*, 99 F. (2d) 588 (C. C. A. 6th), certiorari denied, No. 692, 693, October Term, 1938, April 17, 1939; *Starr* v. *Commissioner*, 82 F. (2d) 964 (C. C. A. 4th), certiorari denied, 298 U. S. 680; *Alles Realty Corp.* v. *Commissioner*, 71 F. (2d) 150, 151 (C. C. A. 2d); *Prairie Oil & Gas Co.* v. *Motter*, 66 F. (2d) 309, 311 (C. C. A. 10th). The opinion of the court below would have permitted the deduction even though the taxpayer had originally borrowed the shares as a personal indebtedness, say, to build a residence. It is plain, however, that the character of a payment upon a liability or debt can be determined only in the light of the purpose and history of the obligation. In ignoring those factors, the court below rendered a decision conflicting in principle with *Menihan* v. *Commissioner*, 79 F. (2d) 304, cited *supra*, p. 10; *Cripple Creek Coal Co.* v. *Commissioner*, 63 F. (2d) 829 (C. C. A. 7th).

In *Menihan* v. *Commissioner*, the court rejected the taxpayer's claim that he had suffered a loss because he had made payment, without recourse, upon a liability which at the time of payment was his own liability. The court inquired into the history of the liability, and determined that originally the taxpayer had endorsed a corporation note to protect his investment in its stock, and that the

creditors' adjustment which made this his own primary debt without recourse was part of an entire arrangement which preserved the value of his shares and represented a capital contribution. In the *Cripple Creek Coal Co.* case, the court held that certain payments were not for ordinary and necessary expenses since in substance they represented instalments in satisfaction of a debt owing to a customer because of its advances toward the cost of a spur track, and therefore the payments were a capital investment. See also *Commissioner* v. *Ashland Oil Co., supra,* where the cost of borrowing money was held a part of the cost of the property purchased with the borrowed money.

3. Moreover, apart from the grounds argued above for the disallowance of the deduction, the court below erred in assuming that conserving and enhancing one's estate constitutes the carrying on of a trade or business, within the meaning of Section 23 (a).[*] Practically everyone devotes time and energy to the conservation and enhancement of his estate, and to consideration of the prudence of his investments. This is not considered a "business." *Kane* v. *Commissioner,* 100 F. (2d)

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[*] In *du Pont* v. *Commissioner*, 37 B. T. A. 1198, 1273, 1274, the Board assumed, without deciding, that petitioner was in the business of an investor, managing his investments. It disallowed the deduction on the grounds stated in the opinion of the District Court below.

382 (C. C. A. 2d); [7] see *Van Wart* v. *Commissioner*, 295 U. S. 112, 116, and cases cited; *Monell* v. *Helvering*, 70 F. (2d) 631 (C. C. A. 2d). Such an investment expense is a personal one, the deduction of which is specifically prohibited by the Revenue Act. Section 24 (a), *supra*, p. 2.

The opinion below serves to obliterate the distinction between personal and business expenses. It permits a taxpayer to convert purely personal and capital expenses into ordinary and necessary expenses by the simple expedient of treating the conservation of his estate as a business, and proceeding to deduct the expense of "conserving" his

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[7] In *Kane* v. *Commissioner*, the taxpayer, through her agent, "changed investments continually, substituting and changing, and reinvesting the income." The court noted that the proof did not show the extent of the activity in the purchase and sale of securities, and ruled that it would not constitute a business for the taxpayer to do merely "what is necessary from an investment point of view," or "to secure or attempt to secure income or capital stability" (100 F. (2d) at 383). Other decisions have indicated that investment activity may constitute a business, if it is sufficiently extensive and regular. *Kales* v. *Commissioner*, 101 F. (2d) 35 (C. C. A. 6th); see *Miller* v. *Commissioner*, 102 F. (2d) 476, 479 (C. C. A. 9th). It is not clear that these decisions would control the present case. Taxpayer testified that he changed his investments in "quite a number of transactions" (R. 153, 156), that he spent 50 per cent. of his time in "looking after my investments" (R. 151), and had two offices (R. 152–153). In any event these decisions are unsound since they simply lead to the conclusion that a wealthy investor, whose investments necessarily generate more activity, may deduct investment expenses while the average, moderate investor may not.

estate by doing an act resulting in deferring liquidation of his personal indebtedness.

4. The taxpayer sold the stock to the committeemen in 1919 without relinquishing ownership of any shares, but borrowing those necessary to make delivery. In other words, he used the mechanics of a short sale, although he did not have the intention to make a profit which characterizes the usual short sale. If this be deemed a short sale, the decision below is in conflict with *Terbell* v. *Commissioner*, 71 F. (2d) 1017 (C. C. A. 2d), affirming, 29 B. T. A. 44. In that case the taxpayer in 1928 sold short 9,000 shares of corporate stock. In order to make delivery of the stock, he borrowed an equal number of shares and delivered them to the purchaser. As part of the contract in borrowing the 9,000 shares, taxpayer had obligated himself to pay to the lender a sum equal to the dividends declared and paid during the year. The Board of Tax Appeals approved the Commissioner's determination that the sum, equal in amount to the dividends, paid over by the borrower was an item of cost to be taken into consideration when the transaction was completed by a covering purchase, and that it was not an ordinary and necessary business expense. The Board also stated that the taxpayer was not in the business of making short sales or dealing in securities generally, but this statement, if material, was at most an alternative ground of decision, since a capital expenditure

does not become an ordinary and necessary expense merely because the taxpayer is engaged in business. *Helvering* v. *Winmill,* 305 U. S. 79. The Circuit Court of Appeals for the Second Circuit affirmed the Board *per curiam.* One of the cases cited by it dealt with the definition of the business of buying and selling securities (*Bedell* v. *Commissioner,* 30 F. (2d) 622 (C. C. A. 2d)), but the other two citations held a certain expenditure to be a capital item (*Bonwit Teller & Co.* v. *Commissioner,* 53 F. (2d) 381 (C. C. A. 2d), certiorari denied, 284 U. S. 690; *Central Bank Block Assn.* v. *Commissioner,* 57 F. (2d) 5 (C. C. A. 5th)). And compare *Commissioner* v. *Ashland Oil Co., supra,* holding that where money is borrowed in order to purchase a capital asset the expense of borrowing is part of the cost of the capital item.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that this petition be granted.

ROBERT H. JACKSON,
Solicitor General.

JUNE, 1939.

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